Dirks v. SEC: A Setback to the SEC's Insider Trading Program

By Stanley Sporkin*

Approximately two weeks ago, the Supreme Court handed down one of its term-ending decisions which, because of the other block-busting cases it had just decided (such as the congressional veto, abortion and legislative prayer decisions), received less public attention than it normally would have, except among those who practice in the securities law field. Dirks v. SEC is an extremely important case. Some see it as a serious setback to the Securities and Exchange Commission's efforts to curtail improper insider trading practices. The case arose out of one of the most egregious corporate frauds of modern times. Equity Funding Corporation, the now-defunct corporation involved in the fraud, has virtually become a generic term for the type of fraud found in the case--the creation of fictitious assets and revenues largely from the writing and reinsurance of nonexistent insurance policies--just as the infamous Ponzi case of many decades ago became a generic description for financial pyramiding schemes.

Equity Funding was a bizarre case from many different angles. Its facts defy belief. It is incomprehensible that such a prominent, profitable and viable corporation could have engaged in such flagrant fraudulent activities for such a long period of time without detection. This is particularly so, since the company was not only required to make filings pursuant to the federal securities laws, but was also subject to the regulatory sphere of a number of state insurance commissions and to the close scrutiny of its own indpendent auditors.

The incredible manner in which the fraud was revealed is equally bizarre. Ronald Secrist, a former employee of Equity Funding, decided that the best way to bring attention to the wrongdoing at the company was to disclose the facts to Raymond Dirks, a key employee of a New York broker-dealer firm with a large customer following in insurance company stocks. It was Secrist's plan to have Dirks disseminate the information to his clients who would then unload their Equity Funding securities on the market causing the price of the stock to fall and triggering a reaction from authorities. The plan worked to perfection. The price of Equity Funding shares in a few weeks dropped from $26 to $15. Dirks' clients alone unloaded securities worth close to $15 million.

This market activity, along with the unconfirmed Secrist information brought to the SEC's attention by a Wall Street Journal reporter prompted the SEC to investigate. After confirming

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the colossal fraud, the SEC brought civil injunctive proceedings and recommended that criminal proceedings be brought against Equity Funding, its key officers and others.

Subsequently, the SEC inquired into the trading of Dirks and his clients. Finding that Dirks' institutional clients, on the basis of non-public information provided them by Dirks, had dumped on the market to unsuspecting investors approximately $15 million of Equity Funding securities, the SEC instituted an administrative proceeding against Dirks and certain of his clients. Dirks was ultimately censured by the SEC for his activities.

The action against Dirks was not brought in order to discredit him. Rather, the administrative proceeding against Dirks and his tippees was instituted because of the perceived violations of the securities laws, particularly to establish that those laws do not license persons to profit through the use of inside information regardless of the motives of the persons who may have precipitated the trading.

Prior to the Supreme Court decision, each of the tribunals that had heard the case agreed that it was wrong for Dirks to tip his clients and for them to have profitted from their transactions in Equity Funding securities.

The Supreme Court in a 6 to 3 decision decided that the tribunals below had erred. It conceded that Dirks had received material, non-public information from insiders of Equity Funding, and that Dirks had disclosed the information to his customers who relied on it in their sales of Equity Funding shares. But despite these consessions, the Supreme Court concluded that the insider trading laws had not been violated. The Court held that, in order to constitute a violation of the statute, the insider who provides the information must breach a duty he has to the company or to its shareholders. According to the decision, such a breach can arise only if the insider in providing the information to an outsider, does so to obtain a personal benefit or gain. The Supreme Court found that Secrist, having no such motive or intent, did not breach his duty to the corporation and, since Dirks received the information from Secrist, his liability was strictly derivative. The Court reasoned if Secrist did not violate the law then Dirks could not be held accountable for his actions.

Those who believe that our capital market system is enhanced by a regulatory program that discourages the misuse of inside information were disappointed in the Dirks decision. The United States enjoys the finest system of capital formation in the world. A key ingredient of our system is the efficient

functioning of fair and honest trading markets. When the laws governing the system were first proposed in the early 1930s, it was deemed that full and fair disclosure would be the most important ingredient to enhance the creditability of our market mechanism. While there were a number of regulatory models that could have been selected by the federal lawmakers, it was concluded that investors should be able to make up their own minds as to what security they should buy or sell and that a more protective system, as some suggested, would have been unwise. It was agreed, however, that investors needed assistance in arriving at their investment decisions. This assistance could best be provided by a system requiring full disclosure of material corporate information.

Corporate securities have always been considered to be intrinsic merchandise since a stock certificate reveals very little about a company. The underlying facts about a company are the necessary ingredients for informed investing.

The SEC has long sought to curb improper trading practices--recognizing there can be no more destabilizing practice than a market where it is perceived insiders are exploiting their privileged status. In Dirks, the Supreme Court criticized the Commission for going too far in striving for what it termed "equal information among all traders." This has not been the Commission's position, for clearly equality of information is an objective which is impossible to achieve. Some persons by reason of superior intelligence, schooling, experience, or business acumen are simply possessed with more knowledge and better analytical abilities than others.

The SEC has always been dedicated to eliminating unfairness in the market place resulting from a person abusing his insider position. Persons should not be permitted to utilize their position as officials of a publicly traded company to obtain for themselves or provide others with profits at the expense of innocent and unsuspecting shareholders or other investors. The governing rules should not depend on the motive or intent of the insider or his relationship to the person to whom he may pass the information. The law should require an insider to "disclose" or abstain from trading.

Now that the Supreme Court has spoken, it is clear that this position cannot be sustained in this encompassing form absent congressional action. While I understand the rationale behind the Supreme Court decision, I submit that the holding was not preordained.

The statutes and rules under consideration in the Dirks case are embodied in the Securities Exchange Act of 1934. That Act in its very preamble specifically states: "To

provide for the regulation of securities exchanges and of over-the-counter markets ... to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes." Section 2 of the Act in further elaboration of the law's defined purposes notes that our capital markets "are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions ... including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order ... to insure the maintenance of fair and honest markets in such transactions."

With such a comprehensive pro-investor statutory tilt, the Supreme Court could have easily concluded that material corporate information cannot be used by insiders or their tippees to trade securities without first disclosing that information. Some believe the integrity of our markets requires no less of a standard.

While the SEC can continue to pursue its aggressive anti-insider trading program under the strictures of the Dirks decision, I submit it will not be able to achieve the full protection that the public securities markets demand. Each new revelation of improper insider trading will become fact and investigative intensive in order to meet the standards enunciated by the Supreme Court. Each case will require proof that the insider, by reason of his position, obtained material corporate information and then utilized it himself or passed it along for "pecuniary gain or a reputational benefit that will translate into future earnings." Thus, the purpose of the insider will have to be determined in each instance. Moreover, to hold a tippee liable, the SEC will have to establish not only that the insider breached his duty in passing along the information but also that the tippee knew or should have known that there had been a breach by the insider. Rather than creating the certainty the Court seeks, the decision will create enormous litigation issues.

The standards enunciated in the Dirks decision in looking to the motives of the insider and his tippee run counter to the original purposes underlying the Exchange Act. While the SEC will still be able to bring the "hardcore" cases, its efforts in curtailing tipping and enhancing the integrity of the market place have been considerably weakened. The law governing insider trading practices is clearly in need of congressional adjustment.